DEPARTMENT OF STATE REVENUE

LETTER OF FINDINGS NUMBER: 98-0480
Adjusted Gross Income Tax – Unitary (Combined) Filing Status
Fiscal Years 1995 and 1996

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ISSUES

Adjusted Gross Income Tax—Unitary (Combined) Filing Status

Authority: *Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992); *Container Corp. v. Franchise Tax Board*, 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948, n. 19 (1983)
IC 6-3-2-2(l); IC 6-3-2-2(p); IC 6-3-2-2(q)
35 ILCS 5/1501(a)(27); Tenn.Code Ann. § 67-4-2004(25)(B)

Taxpayer protests the Audit Division's subsequent disallowance of unitary combined filing status, for purposes of the taxpayer's combined adjusted income tax return reporting for fiscal years 1995 and 1996, on the basis that the combined return inaccurately reported taxpayer's Indiana income.

STATEMENT OF FACTS

Taxpayer's parent corporation (hereinafter, "Parent") develops and manufactures electronic parts and assemblies. At the time of the audit, Parent maintained subsidiary manufacturing service centers in several locations in the United States and Canada, which included subsidiaries in Michigan and Indiana. The Michigan and Indiana subsidiaries were an automotive unit which produced shifter systems, parking-brake mechanisms, brake pedals, underbody spare-tire carriers, and airbag components. The "taxpayer" in the instant case is the Indiana subsidiary.

In July of 1995, Parent filed a petition for permission to file Indiana unitary combined returns with the Indiana and Michigan subsidiaries for the fiscal year 1995 and subsequent tax years. In its petition, Parent maintained that both the Michigan and Indiana subsidiaries were one hundred percent (100%) owned by Parent; that operationally, the Michigan and Indiana subsidiaries were one entity; that the administration and management of the two subsidiaries were located at the offices of the Michigan subsidiary; that all decisions regarding the operations of both subsidiaries were made at the Michigan subsidiary's offices in Michigan; and, that the subsidiaries shared officers and a board of directors.

In a letter dated August 30, 1995, and based upon the information submitted by Parent, the Indiana Department of Revenue granted Parent's request to file unitary combined returns in Indiana for fiscal year 1995 forward. Specifically, the Department found that Parent and its Michigan and Indiana subsidiaries met the unity requirements through its unity of ownership, centralized management, and centralized financial, administrative and operational services. (*See Department of Revenue-Tax Policy Division Letter* dated August 30, 1995, page 2). The Department further found that Parent and its subsidiaries met the "best method for reporting adjusted gross income" test through its shared industry impact on Indiana adjusted gross income, its interdependency of operation, and its coordination of the production process and production facilities. (*See Department of Revenue-Tax Policy Division Letter* dated August 30, 1995, page 3). Nevertheless, the Department reserved the right to revoke its grant of permission for unitary combined filing in the event that, *inter alia*, the facts subsequently established by the Department disclosed material error or misrepresentation of the facts set forth in Parent's original petition. (*See Department of Revenue-Tax Policy Division Letter* dated August 30, 1995, page 3).

Subsequent to its determination in its August 30, 1995 letter, the Department conducted an audit of Parent's Indiana subsidiary (*i.e.*, taxpayer) for the fiscal years 1995 and 1996. The Department's auditor determined that the unitary combined returns should not have been allowed because taxpayer was unable to prove that the combined return reporting method more fairly represented the adjusted gross income attributable to Indiana. According to the auditor, the Indiana adjusted gross income is more fairly represented by filing separate company returns.

Adjusted Gross Income Tax—Unitary (Combined) Filing Status

DISCUSSION

The taxpayer (*i.e.*, the Indiana subsidiary) protests the auditor's determination that it may not file unitary combined returns for the fiscal years in question. Taxpayer argues that the combined reporting is the only filing method that fairly represents the flow of value from functional integration, centralized management, and economies of scale, present between taxpayer and the Michigan subsidiary. According to taxpayer, because the Michigan and Indiana subsidiaries operate as one operating entity, the filing of separate

company returns would result in an unfair and distorted apportionment of income to Indiana.

Before we address whether the Audit Division erred in determining that taxpayer may not file unitary combined returns, we first address whether the Department may retroactively withdraw permission to file unitary combined returns. Taxpayer questions the Department's ability to challenge its earlier grant of permission to file combined returns without a finding of some material misstatement of fact.

On August 30, 1995, the Department granted taxpayer the right to file combined returns in a letter, stating in pertinent part: "Permission is hereby granted to [taxpayer and the Michigan subsidiary, and required of Parent], to file combined/unitary returns for adjusted gross income and supplemental net income tax effective for tax year ended June 30, 1995." (*See Department of Revenue-Tax Policy Division Letter* dated August 30, 1995, page 3). The statute applicable to the permission issue is found in IC 6-3-2-2 which states in pertinent part that:

> IC 6-3-2-2 Corporations and nonresidents; "adjusted gross income derived from sources in state" defined . . .
>
> (l) If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana . . .
>
> (q) . . . taxpayers may petition the department . . . for permission to file a combined income tax return for a taxable year. The petition to file a combined income tax return must be completed and filed with the department not more than thirty (30) days after the end of the taxpayer's taxable year.

(*See Department of Revenue-Tax Policy Division Letter* dated August 30, 1995, page 3).

The Department's grant of permission to file combined returns was a determination, based upon the facts available to the Department at the time, upon which taxpayer could rely. However, the Department did reserve the right to revoke the grant of permission if, *inter alia*, "the facts subsequently established by the Department disclose material error or misrepresentation to the facts set forth in this petition." (*See Department of Revenue-Tax Policy Division Letter* dated August 30, 1995, page 3). This right of revocation was clearly set forth in the letter to taxpayer. And, the language of the letter clearly warned taxpayer that should a subsequent audit reveal a misrepresentation of the facts set forth originally, permission to file combined returns would be revoked. The Audit Division performed an audit for the years in question and determined that the combined filing method did not fairly reflect taxpayer's Indiana income and issued an assessment against taxpayer. We find nothing in the rules or statutes that prohibits the Department from determining whether taxpayer's assertions, in light of more contemporary audit findings, rise to the level of material error or misrepresentation of fact such that taxpayer's combined filing status should be revoked.

We now turn to the question of whether the Audit Division erred in determining that taxpayer's combined filing status should be disallowed on the basis that the combined return inaccurately reported taxpayer's Indiana income. In addressing this question, we examine: (1) whether a unitary relationship actually exists between Parent and taxpayer; and (2) whether filing a combined return would more fairly represent the Parent's and taxpayer's Indiana income.

The Supreme Court over the years has developed a three-part test in determining whether a unitary relationship exists: common ownership, common management, and common use or operation. *See, e.g., Mobil Oil Corporation v. Commissioner of Taxes of Vermont*, 445 U.S. 425, 100 S.Ct. 1223 (1980); *Exxon Corp. v. Department of Revenue of Wisconsin*, 447 U.S. 207, 100 S.Ct. 2109 (1980); *ASARCO, Inc. v. Idaho State Tax Commission*, 458 U.S. 307, 102 S.Ct. 3103 (1982); *F.W. Woolworth v. Taxation and Revenue Department of New Mexico*, 458 U.S. 354, 102 S.Ct. 3128 (1982); *Allied-Signal, Inc. v. Director, Division of Taxation*, 504 U.S. 768, 112 S.Ct. 2251 (1992). The first item to be considered under this three-part test is common ownership. As a general rule, at least fifty percent (50%) of a corporation's stock must be commonly owned (either directly or indirectly) in order for a corporation to be considered part of a unitary business. *See, i.e.*, 35 ILCS 5/1501(a)(27) and Tenn.Code Ann. § 67-4-2004(25)(B). The information in taxpayer's file shows that during the audit period Parent owned one hundred percent (100%) of the stock of taxpayer. The evidence of file is sufficient to establish common ownership.

The second criteria to be considered is common management. Common management is shown when the parent corporation provides a management role that is grounded in the parent's own operation expertise and overall operational strategy. *See, e.g., Container Corp. V. Franchise Tax Board*, 463 U.S. 159, 180, n. 19, 103 S.Ct. 2933, 2948, n. 19 (1983).

Here, the taxpayer has supplied evidence which shows that Parent exercised control and influence over it and the Michigan subsidiary. Parent, through Parent's finance division, consisted of six (6) officers, Chairman, President, Vice President-Secretary, Vice President-Treasurer, Vice President-General Counsel, and Assistant Treasurer; and two (2) professional staff, the Director of Employee Benefits and the Director of Corporate Communications. Each one of Parent's subsidiary groups was headed by a Vice President-General Manager (VP-GM). (Taxpayer and the Michigan subsidiary together comprised one subsidiary group (hereinafter referred to together as, the "Group")). Parent's board of directors controlled all of the subsidiaries. The VP-GM's of the subsidiary groups reported directly to the executive officers of the finance division. To obtain operating funds, the VP-GM's were required to send a request to the finance division treasurer. All excess funds were remitted to the finance division to reduce the line of credit. Additionally, Corporate Counsel routinely reviewed the subsidiary groups from the standpoint of insuring both compliance with applicable laws and regulations, as well as the practice of preventative law. We find that common management existed between Parent and Group.

The third test is that of common operation or use. Evidence of a common operation exists where certain functions are performed for the group by the parent (such as purchasing, financing, advertising, marketing, research, tax compliance, insurance, and pension plan management) which independent companies would perform for themselves.

In the taxpayer's case, information was supplied which shows that many of the administrative, management, and financing functions for the Parent's subsidiaries were centralized. All short-term financing, income tax return filing, legal support, and insurance coverage for the Group and the other subsidiaries was provided by Parent's finance division. Parent's finance division provided administrative and management assistance to the Group and the other subsidiaries with their respective defined benefit plans and worker's compensation claims. The finance division reviewed the marketing information prepared by the management units of the subsidiaries before the printing and distribution of said marketing materials. The finance division also supervised the commercial preparation of most preprinted marketing information, and arranged photograph sessions and commercial printer selection.

On the basis of these facts, we cannot say that the Department's finding that taxpayer enjoyed a unitary relationship with Parent and the Michigan subsidiary was against the weight of the evidence of file. There exists the elements of common ownership and management, and a modicum flow of value between the members of the business group. Using Parent's staff to provide services for taxpayer and the Michigan subsidiary that said taxpayer and subsidiary could have provided for themselves, resulted in common operation.

We now turn to the next point of analysis and the question of whether requiring taxpayer to use a standard apportionment or separate company filing method, instead of combined return filing, would result in a distortion of the income Parent reported as Indiana source income. Ultimately, this question requires us to determine whether, under all of the circumstances of the unitary relationship between Parent and the Michigan and Indiana subsidiaries, standard apportionment fulfills the statutory purpose of avoiding distortion of and realistically portraying Indiana source income. *See* IC 6-3-2-2(p).

Although IC 6-3-2-2(q) allows a parent corporation to petition the Department to file a combined return, it also incorporates by reference the restrictions imposed on alternative methods of reporting adjusted gross income by subsection (l) of that same section. Subsection (l) states in pertinent part:

> If the allocation and apportionment provisions of this article do not fairly represent the taxpayer's income derived from sources within the state of Indiana, the taxpayer may petition for or the department may require, in respect to all or any part of the taxpayer's business activity, if reasonable:
>
> > (4) the employment of any other method to effectuate an equitable allocation and apportionment of the taxpayer's income.

It is clear from the language in subsection (l) that the standard apportionment and the separate accounting filing methods are the preferred methods of representing a taxpayer's income derived from Indiana sources. Other methods of income allocation and apportionment (including the combined reporting method) should only be allowed when those provided for by IC 6-3-2-2 do not fairly reflect a taxpayer's Indiana income. As stated in a more concise manner, if the Indiana source income in the instant case can be fairly represented on the basis of standard apportionment or separate accounting, then such filing methods should be used.

The foundation of much of taxpayer's argument rests upon its assertions that it is impossible and inequitable to attribute Indiana income to it on a separate accounting basis since, due to the unitary nature of the relationship between Parent, taxpayer and the Michigan subsidiary, the production processes of taxpayer and the Michigan subsidiary were so interdependent that taxpayer's Indiana income could not be separately determined. However, despite the finding of a unitary relationship between Parent, taxpayer and the Michigan subsidiary, and despite the relationship between taxpayer's and the Michigan subsidiary's business operations, it does not appear that the operations of the businesses were so integrated to the point where the filing of separate returns would lead to a distortion of income.

Taxpayer would have us believe that it was nothing more than a corporate shell for identical business operations conducted directly by the Michigan subsidiary; and, that no value could be assigned to the products produced at the Indiana facility. However, the Department determined that Parent operated a unitary business where each operation contributed to the business as a whole, and that the income-producing activities and sources within Indiana could be differentiated from the income-producing activities and sources outside of Indiana. Taxpayer had its own employees that performed the work assigned to the facility. Taxpayer received orders and completed the production cycle of raw material to finished product within its facility. The production of product at taxpayer's facility was "self-contained" and not linked with the production that occurred at the Michigan facility.

Notwithstanding the foregoing, we do not believe that the Audit Division's subsequent revocation of the Department's determination that taxpayer could file combined tax returns was due to a material error or misrepresentation. The original approval letter specifically stated that combined filing status would be revoked if a material error or misrepresentation was discovered. However, through its examination of the books, records, and property of taxpayer, and its determination that separate filing best represented the taxpayer's Indiana income, Audit did not appear to discover any material error or misrepresentation on the part of taxpayer.

Upon review of the instant case, the Department concludes that the original approval letter granting taxpayer permission to file combined tax returns is in error, but was not the result of a material error or misrepresentation on the part of taxpayer in the application process. Therefore, the appropriate remedy is for taxpayer's combined filings for the years in question to be allowed.

FINDING

Taxpayer’s protest is sustained. Taxpayer's combined returns for tax years in question will be allowed. However, taxpayer's permission to file combined tax returns is revoked for tax years beginning after the date of the audit report.

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